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Why your shareholder vote may not count

Posted by Fortune Editors

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Because of poor record keeping and a lack of regulatory oversight today, your vote, as a shareholder, may not be counted.

By Eleanor Bloxham, contributor

The alarm bells regarding the abusive back office processes of mortgage servicers were ringing back in 2007, but they mainly fell on deaf ears.

Legal scholar Katherine Porter's 2007 review of 1,700 cases in *Misbehavior and Mistake in Bankruptcy Mortgage Claims* concluded that "a majority of mortgage claims lack the required documentation necessary to establish a valid debt", fees are charged that "do not appear to be legally permissible", and that "the bankruptcy system routinely processes mortgage claims that cannot be validated and are not, in fact, lawful."

And state regulators sought federal regulatory assistance three years ago due to foreclosure issues they had uncovered at Bank of America (BAC) and JP Morgan (JPM). The regulators were ignored by the Office of the Comptroller of the Currency.

Despite the warnings, it was not until people losing their homes in record numbers began to speak out that the issues really came into the spotlight, forcing banks to seriously review and own up to issues with their internal processes.

Now, silently, there is another back office issue brewing that may soon come to a head, this time at brokerage houses. While not as devastating as losing a home, the issue goes to the very heart of capitalism -- losing your shareholder vote. Because of poor record keeping and a lack of regulatory oversight today, your vote, as a shareholder, may not be counted.

How this happened

Your potential lack of suffrage stems from a fix to make back office recordkeeping easier for brokerage firms, according to Carol Hansell, an attorney with Davies Ward Phillips and Vineberg and co-author of *The Quality of the Shareholder Vote in Canada*.

This fix came in response to the "paperwork crisis" of the 1960s. At that time, "a brokerage firm in the United States needed 33 different documents to execute and record a single securities transaction."

With stock market volume soaring by 400% in one decade, brokers were straining to keep all the paperwork straight. As a result, Congress mandated a change to the system. Because of this change, most shares you buy are recorded by your broker and share certificates are held centrally rather than mailed directly to you.

Sounds like a good solution and it could have been just fine.

The problem?

No one thought too much about creating a system to accurately record the voting rights of your shares.

As Ms. Hansell points out, in redesigning the process for share purchases and sales, shareholder votes just weren't considered that important and "the systems were never designed" to make sure the vote counts were accurate.

How big is the problem?

The problem has gotten to the point that **votes closer than a 10% spread are not callable**, according to Gil Sparks, a leading Delaware attorney, quoted in a 2008 report published in the *Georgetown Law Journal*.

That is highly disturbing, given the close elections we've seen in U.S. boardrooms this year. In the **Massey boardroom, for example, in May, two of the three directors up for reelection won reelection by a margin of 10%**, according to SEC filings.

At The Pantry, Inc. (PTRY), **one director earned 47% in support of reelection and 53% against, while three directors earned 48% for and 52% against.**

And research suggests that **incumbents are overwhelmingly more likely to win than lose reelection by small margins.**

Why the interest now?

Although ensuring accurate vote counts has been a festering problem for years, increasingly, shareholder votes do matter.

Just as increased share trading volumes helped fuel the 1960s broker paperwork crisis, which led to reforms in processing, and just as "foreclosuregate" has come to a head with increased volumes of foreclosures, the interest in shareholder voting is picking up steam because of the increased number of issues shareholders are being asked to vote on (say on pay as one new recent example)

and the growing importance of shareholder votes themselves (as director elections move to require majority votes for election, for example).

Couple that with increased shareholder activism and a new focus worldwide on the obligation, as well as the right, of shareholders to vote, and you have the stirrings of what could become a very contentious battlefield over whether votes were counted, over-counted, under-counted or otherwise distorted.

And the discussion is not theoretical. Over the past few years, there have been numerous reports of materials not being delivered in time to shareholders, confusion around who owns shares, and votes not counted.

Just two weeks ago, **the issue of voting irregularities was raised in an SEC filing by Carl Icahn**, reported on by *The New York Times'* Dealbook.

The **filing stated Icahn's view** that "the Dynegy/Blackstone merger severely undervalues the Issuer" and that "In addition to demanding appraisal rights under Delaware law, [Icahn] intend[s] to investigate any potential voting irregularities."

What's next?

In July, the SEC published a concept release on a wide spectrum of issues concerning shareholder votes.

The Securities Transfer Association's white paper that summarized comments on the SEC release said that many issuers have expressed concern with the collection and counting of their shareholder's votes and believe that reform is necessary.

The International Corporate Governance Network (ICGN) offered similar concerns, stating that **share voting record-keeping practices are in need of an upgrade.**

The recommendations for reform make sense -- and they are akin to keeping a list of eligible voters in a government election. But why, if it's so obvious, hasn't it been done?

It likely comes down to the fact that brokerage houses don't have an economic incentive to clean up their act.

"The regulatory push here is needed because broker-dealers may have insufficient incentives to get this right on their own," writes Henry Hu and Bernard Black in *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions.*

Morgan Stanley Smith Barney's comment letter on the SEC's concept release confirms this: "Requiring brokers to change reconciliation methods ... would impose costs and implementation difficulties that would far outweigh the advantages of imposing one method to the exclusion of the other."

So where is the Financial Industry Regulatory Authority (FINRA), the overseer of broker dealers, in the process?

FINRA did not provide comments on the concept release and didn't have a comment related to its current role or its future plans in this area.

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For shareholders with elections this spring, will their votes count or will we continue to have a situation where we just don't know?

Darren Robbins of Robbins, Geller, Rudman and Dowd, the law firm that pursued Enron on behalf of investor victims, says on close shareholder votes you have to "wonder about their veracity". And the implementation of the Dodd-Frank financial reforms will only make these issues more acute, he noted.

"While mechanisms to track votes in single situations may be possible, to recreate them in 10, 20 situations, could put a real strain on the system. The SEC should be compelled to look at this," Robbins says.

An SEC spokesperson said that it is evaluating public comments related to their concept release with next steps to be determined. The spokesperson did not know what the timeline might be or the extent to which FINRA may be involved.

One suggestion before next proxy season?

The SEC and FINRA will be holding a broker dealer seminar on Feb. 8, 2011, at the SEC's Washington, D.C. headquarters.

Shareholder votes -- and knowing who is entitled to vote -- should be on that agenda.

Eleanor Bloxham is CEO of The Value Alliance and Corporate Governance Alliance, a board advisory firm.

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